WILSHIRE
CONSULTING

Attachment 1

Andrew Junkin, CFA, CIMA, CAIA
Managing Director

September 25, 2008

Ms. Anne Stausboll
Interim Chief Investment Officer
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Corporate Governance Investments Program Review

Dear Anne:

Wilshire has conducted a review of the internally-managed Corporate Governance Investments Program's personnel, investment process, external managers and resources. This review was conducted as part of Wilshire's contractual requirement to periodically review all of the internal asset management functions, and included on-site visits by Wilshire to substantially all of the external managers (both in the US and overseas), an onsite visit with the CalPERS Portfolio Manager overseeing the Corporate Governance Investments Portfolio, and ongoing discussions with both. Overall, we are pleased with the quality of the personnel, systems, external managers and processes, and believe that the Investment Committee should continue to support this program.

As part of our review, Wilshire met with Staff involved with the management of the Program and all of the external managers. We discussed the strategy for each portfolio, how research is conducted, what risk controls are in place, how the portfolio is implemented and how feedback and input are provided at each step of the investment process.

In short, we believe the investment approach is appropriate for the various CalPERS portfolios; Staff is aware of the risks faced by the portfolios, managing those that are diversifiable; and Staff has sufficient resources at its disposal.

We recommend that the Corporate Governance Investments Program continue to be supported by the Investment Committee, as much of the recent performance is explained by the overall portfolio's style bias and the concentrated nature of the holdings. We also recommend that Staff continue to seek to diversify the program, hiring managers with demonstrated skills in identifying and engaging with underperforming companies. This additional diversification should help dampen some of the volatility of the overall program, while continuing to build exposure to a persistent source of alpha that is otherwise unrepresented within CalPERS portfolio.

Summary

The Corporate Governance Investments Program is a component of the Global Equity asset class and includes investments with external managers and co-investments made by Staff in concert with the external managers. The purpose of the Corporate Governance Investments Program is to add value to CalPERS' equity portfolio, exceeding the returns of the internally managed index funds. A spillover effect is that the improvements in corporate governance in the Program's portfolio is also enjoyed by CalPERS' index funds, as they hold substantially all investable equity securities around the globe. Assuming that improvements in corporate governance lead to improved stock performance, the effects of the Program are then magnified throughout the entire equity portfolio.

The process for selecting external managers is a demanding one. There are four key steps: 1) sourcing, 2) internal due diligence, 3) external due diligence, and 4) sizing.

Sourcing new managers for the externally managed portion of the portfolio can be challenging as successful activist approaches require a melding of investment talent with the ability to identify profitable and achievable engagements, and then to persuade corporate management of the benefits of the proposed course of action. In addition, CalPERS has always pursued a friendly-activist approach, rather than risk being viewed as a corporate raider. This is one of CalPERS' core values, but further limits the available talent pool. Sourcing is conducted by Staff (aided by outside resources, such as Wilshire) and greatly benefits from CalPERS' reputation as a shareowner-rights proponent.

Internal due diligence starts with informal discussions and progresses to a formal questionnaire, developed by Staff over the life of the program. The questionnaire focuses on the investment process, the engagement process, the stability of the investment management firm, and the background of the key individuals. The questionnaire is very thorough, and when completed can take up a hundred pages or so. If the questionnaire receives a "passing" score, additional due diligence is conducted by Staff onsite. If that due diligence is deemed successful, an external consultant is engaged to complete independent due diligence.

External due diligence is completed by a consultant selected by the CIO, in conjunction with the SIO-Global Equity and the SPM of Corporate Governance. A favorable due diligence report is required before an investment can be made in a new corporate governance fund. Wilshire has acted as an independent due diligence source on many, but not all, of the Corporate Governance Investment Program's investments. While we cannot speak to the full due diligence process used by other firms, Wilshire's process focuses on the stability of the investment management organization; the alignment of interests between the firm, its key professionals, and CalPERS; the firm's ability to add value through identifying undervalued companies and engaging with corporate management; the ability to control risks; and the ability to successfully implement the investment process through prudent trading practices.

After a favorable due diligence report is rendered on a potential corporate governance fund and Staff has decided to proceed under its delegated authority, Staff decides on the appropriate size of the investment, taking into consideration the expected risk and return characteristics of the new fund and the overall state of the Corporate Governance Investments portfolio. Such considerations may incorporate feedback from Wilshire and the Risk group within CalPERS.

Ongoing monitoring is performed separately by Staff and by Wilshire. Staff and Wilshire then coordinate to discuss any issues or concerns with the portfolio or any of the external managers.

The co-investment process is comprised of five key steps: 1) sourcing, 2) due diligence, 3) trading, 4) monitoring, and 5) exiting the co-investment.

Sourcing for co-investments is an active process between Staff and existing external managers. By policy, co-investments can only be made with managers that have generated outperformance since inception. Staff routinely discusses portfolio companies with managers and co-investment ideas are originally sourced during these discussions.

Once a co-investment is proposed, the proposing manager will prepare a write-up, detailing the rationale behind the co-investment and the keys to unlocking the underlying value through corporate governance tactics. Staff will review the research provided by the manager and conduct their own research, which may include stress testing forecasted financial statements, contacting analysts who cover the company to discuss the prospects for the firm, and reviewing the co-investment in the context of the overall Corporate Governance Investments portfolio. Staff thoroughly reviews each option – accepting some, declining others.

Trading in co-investments is conducted by the CalPERS equity trading desk. Traders will coordinate with the Corporate Governance Staff to establish a timeline and price target for the trade. Wilshire has reviewed CalPERS' trading ability extensively with other internally managed programs and finds that CalPERS has a very effective trading desk that is properly motivated to achieve best execution on all trades.

Ongoing monitoring is conducted by Staff, in conjunction with the co-investment's sponsoring manager. Staff may decide to exit a position it believes has become problematic, even if the co-investment's sponsoring manager still holds the position.

Co-investments are initiated with target engagement topics and associated price targets. As the engagement progresses, Staff will ultimately decide to sell the investment when it is believed that substantially all of the value of the engagement has been realized.

Overall, we believe that the Corporate Governance Investment Program's two investment functions (funds and co-investments) are handled appropriately and receive significant attention from Staff. Wilshire feels that the Corporate Governance Investments portfolio is well diversified, but suggests that continuing to diversify the portfolio with additional funds will dampen the volatility of the active returns associated with activism and will offer a greater variety of co-investment opportunities for Staff to exploit.

Risks

There are two key investment risks that affect the Corporate Governance Investment Program that we have discussed with the Investment Committee on several occasions that should be noted here. First, there is are distinct size and style biases associated with corporate governance investing. Second, due to the concentrated nature of the portfolios and the length of time that is generally required to run a successful engagement campaign, the returns associated with the Program can be very lumpy, even after accounting for the size and style bias.

Successful activist investing typically involves identifying undervalued companies with correctable governance deficiencies that, once corrected, will unlock the true value of the company for all shareowners. Inherent in this is the fact that value identification typically evidences itself as a value bias. Additionally, by definition, underperforming companies (with underperforming common stocks) have smaller market capitalizations relative to their peers. As such, a typical corporate governance portfolio will have both a value bias and a small cap bias. Historically, both of these biases have been rewarded, regardless of whether or not an investor is engaging portfolio companies (although extensive research has been conducted by Professors Fama and French that demonstrates the long-term outperformance of small capitalization value stocks, some debate remains over their findings). However, over periods of time where larger cap stocks outperform smaller cap stocks or periods of time where growth stocks outperform value stocks, activist strategies can lag significantly.

To judge the magnitude of the size and style bias in the portfolio, Wilshire prepared the following analyses. The four charts that follow present the size and style characteristics of the various managers and the domestic and international portfolios relative to broad domestic and international benchmarks.

Chart I
Corporate Governance Investment Program
Domestic Equity Composite

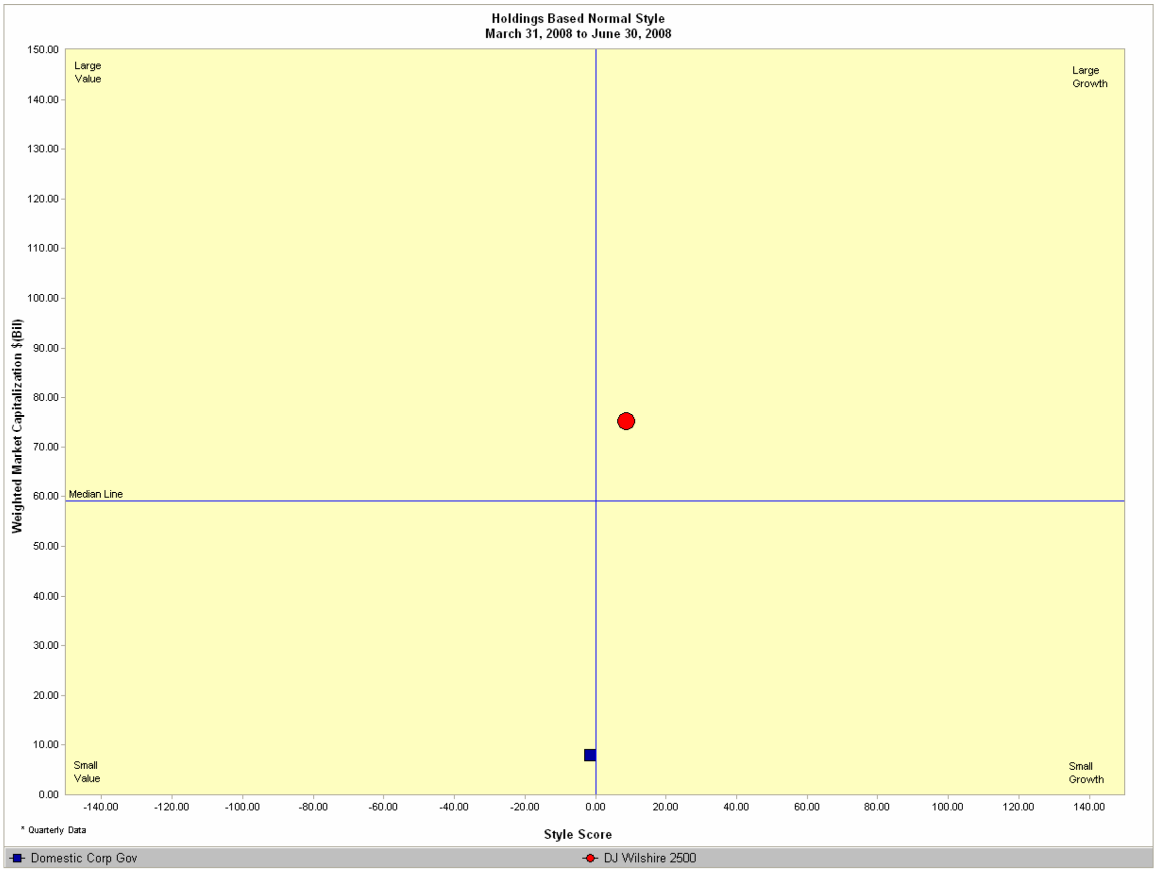
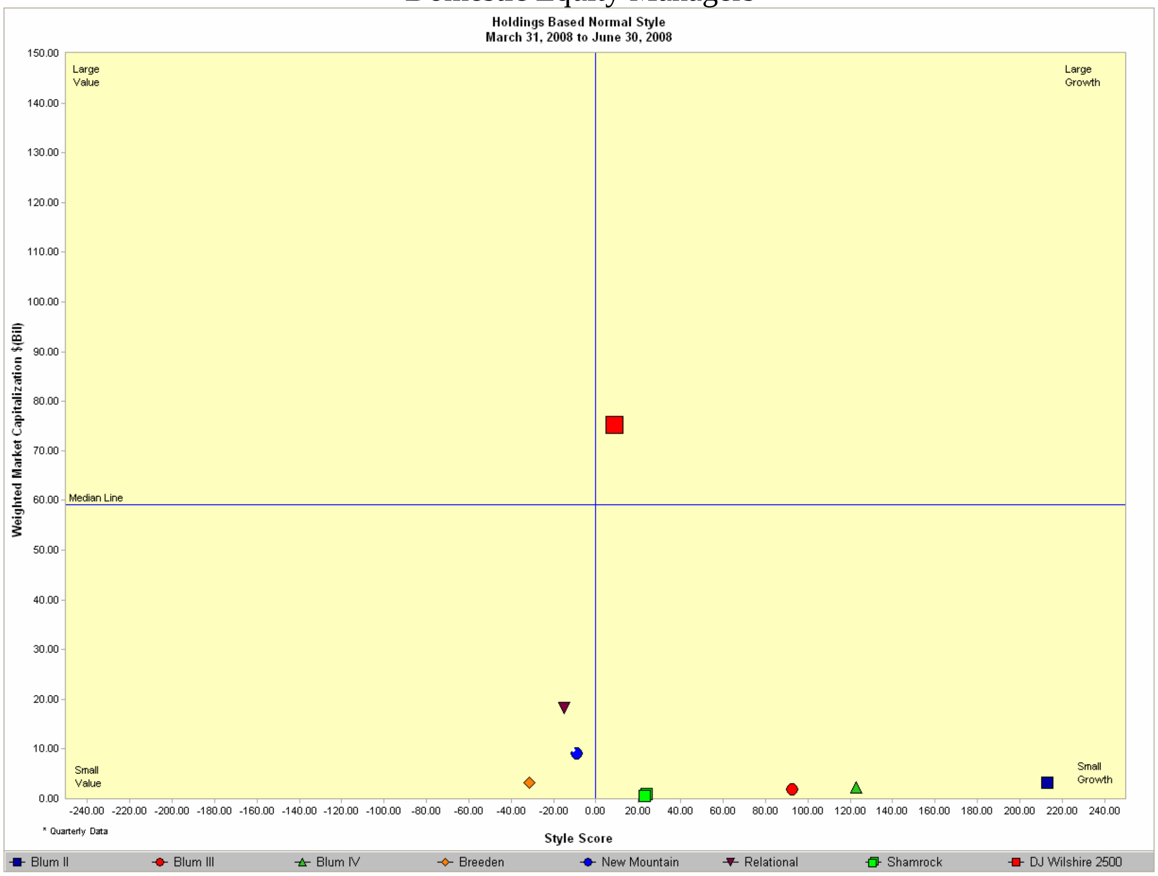


Chart I shows the domestic equity component of the Corporate Governance Investment Portfolio's size and style scores relative to the Dow Jones Wilshire 2500. As you can see, the portfolio exhibits a meaningful small cap bias, although the style bias is relatively moderate.

Chart II
Corporate Governance Investment Program
Domestic Equity Managers



When viewed on a manager by manager basis, you can see that each of the managers has a portfolio that has a smaller weighted market cap than the benchmark. Note that the three Blum portfolios have a growth bias compared to the benchmark, which is unusual, but is simply a result of their current holdings. At purchase, Blum targets undervalued companies.

Chart III
Corporate Governance Investments
International Equity Composite

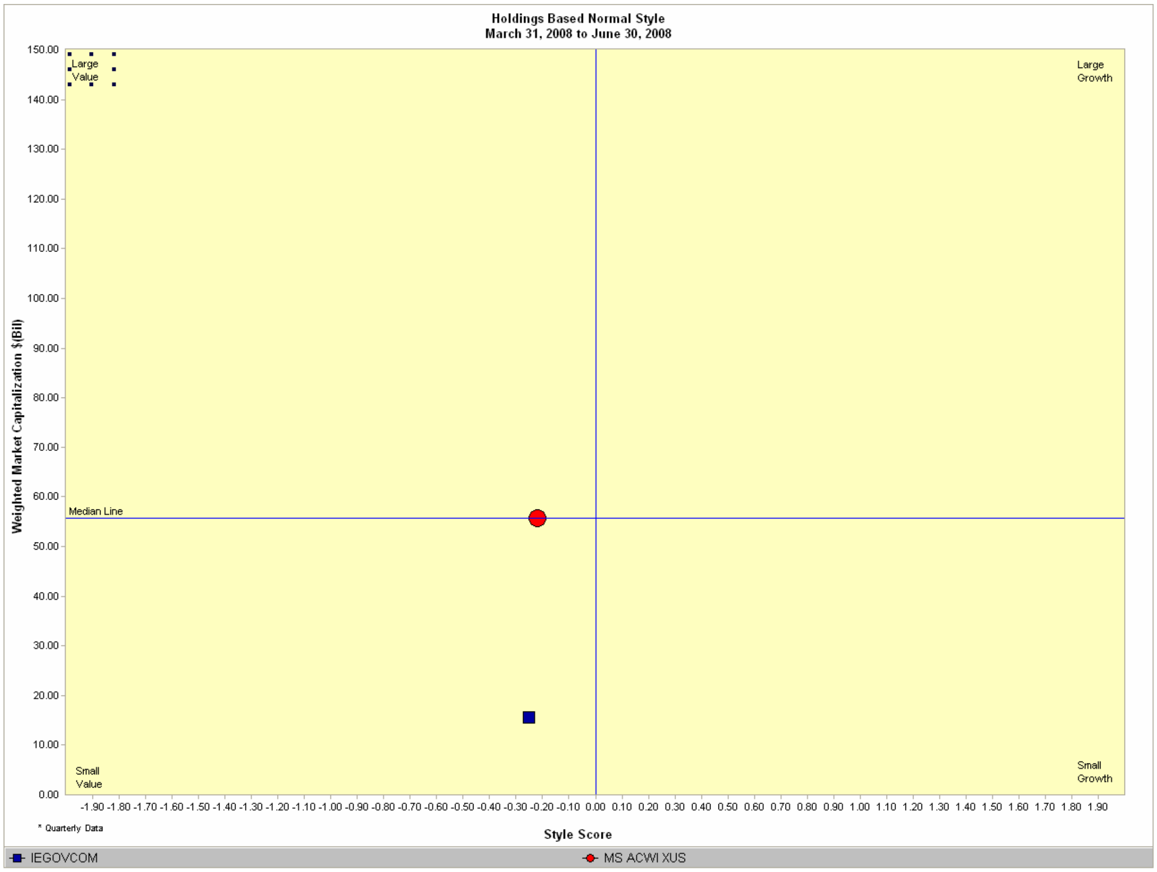


Chart III shows the small cap bias in evidence in the international equity composite.

Chart IV
Corporate Governance Investment Program
International Equity Managers

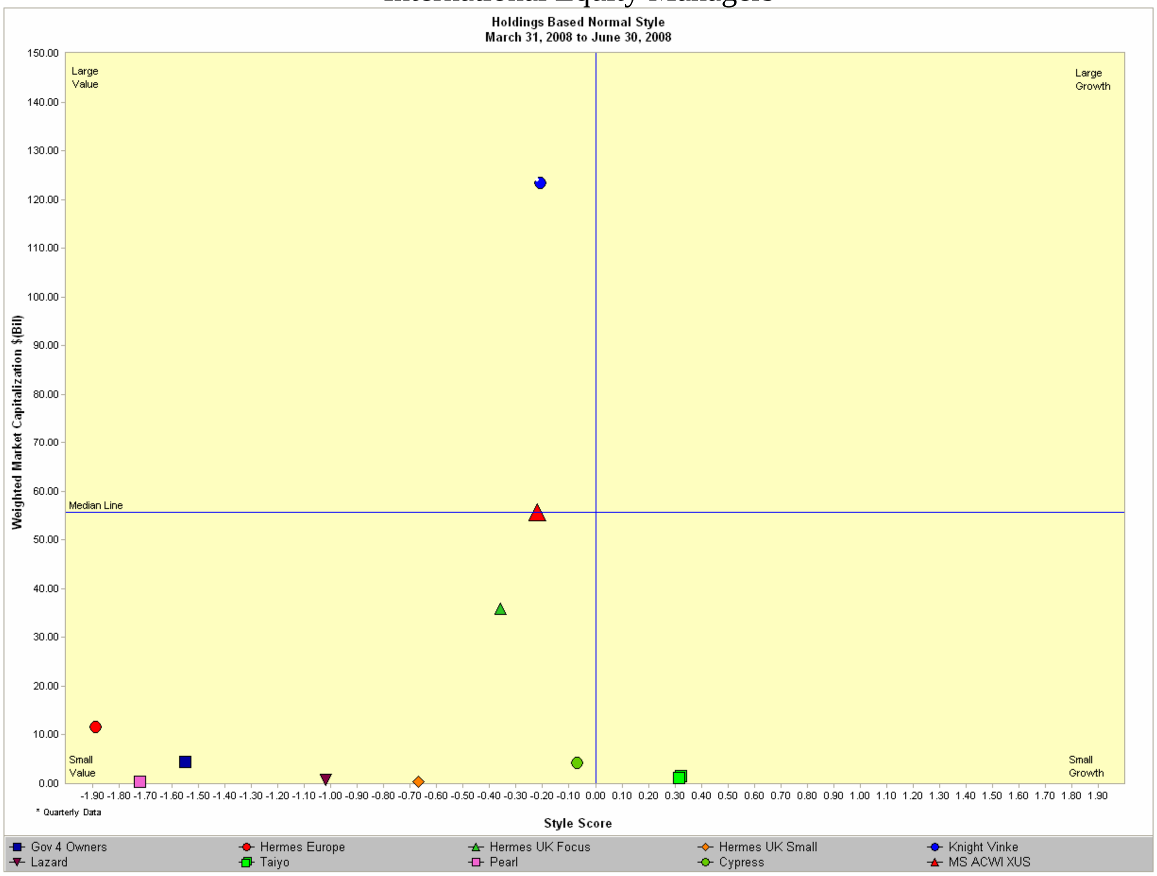
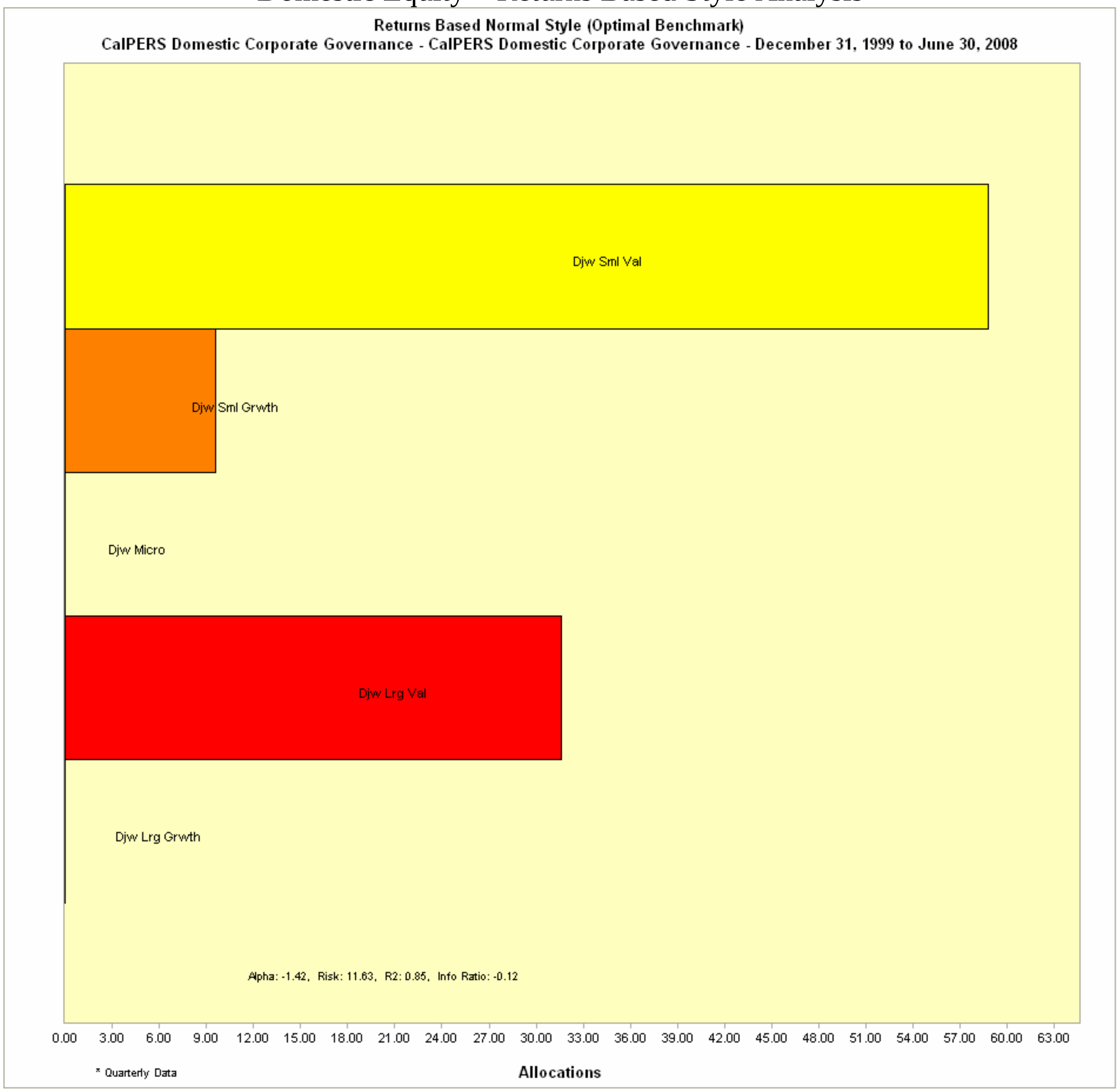


Chart IV shows the small cap bias for each manager and illustrates again that most managers have a pronounced value bias, relative to a broad equity benchmark.

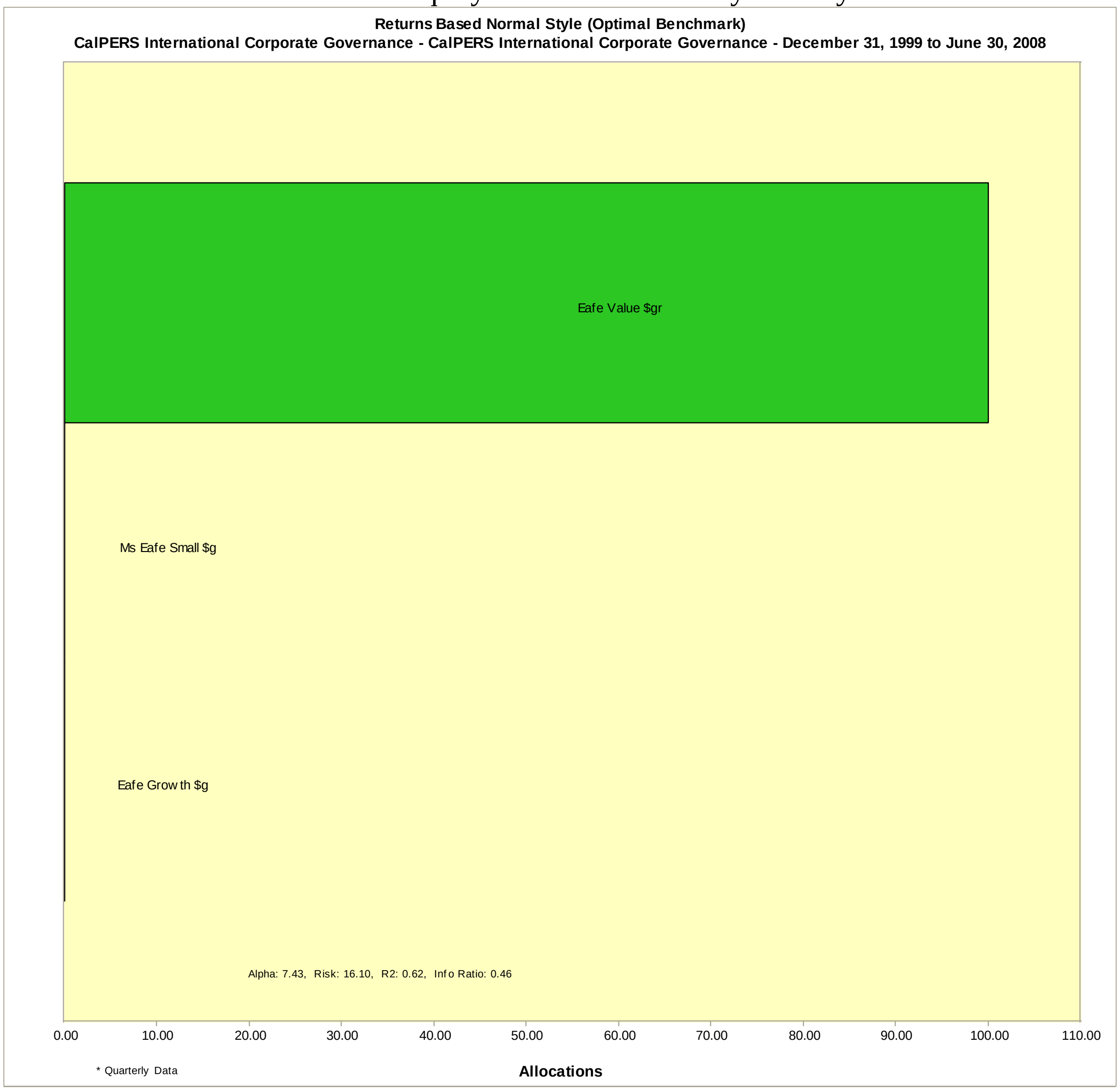
Charts V and VI show the style bias as revealed by returns based style analysis. In this analysis, a regression analysis finds the mixture of return streams that bests fits the returns generated by the domestic and international components of the Program.

Chart V
Corporate Governance Investment Program
Domestic Equity – Returns Based Style Analysis



Domestically, the program's returns have been dominated by value (small and large), representing 90% of the best-fit index's style. The remaining 10% is represented by small cap growth.

Chart VI
Corporate Governance Investment Program
International Equity – Returns Based Style Analysis



Internationally, the style bias appear more evident from a returns based perspective. Fully 100% of the best-fit index is the value (EAFE Value, in this instance).

In addition, the value bias manifests itself in sector weights that are meaningfully different than the benchmark. Table I below shows the relative sector weight of the domestic equity portfolio and the international portfolio, relative to the Dow Jones Wilshire 2500 and the MSCI EAFE indices, respectively.

Relative Sector Weights %		
	Domestic Equity	International Equity
Consumer Discretionary	22.1	13.2
Consumer Staples	-8.8	-5.1
Energy	-10.0	-5.1
Financials	0.1	-16.9
Health Care	4.4	0.8
Industrials	-5.8	10.1
Information Technology	1.4	13.2
Materials	-4.4	-6.1
Telecomm Services	1.6	0.0
Utilities	-0.6	-4.1

First, note that there are meaningful overweights and underweights in almost every sector, both domestically and internationally. This contributes to the active risk level in the overall portfolio, but managers are ultimately pursuing engagements where they feel they can have a meaningfully positive impact on the stock price. Note the overweight in each composite in the Energy sector. Being underweight energy over the past year has broadly resulted in underperformance as oil prices rose dramatically.

The attribution results presented below confirm that industry weights have been a significant factor in the performance of both portfolios over the past year.

Performance Attribution Analysis
Domestic Corporate Governance versus Dow Jones Wilshire 2500 Index
06/30/2007 - 06/30/2008

Sources of Returns - Domestic:	**Portfolio**	**Benchmark**	**Managemen**
Log Market Cap	2.7	0.8	1.9
E/P Ratio	0.7	-0.1	0.8
Book/Price	-4.8	-2.4	-2.4
Volatility	-0.4	-1.1	0.7
Momentum	-2.4	0.1	-2.5
Historic Beta	-0.9	-0.8	-0.1
Msindgrp	-17.5	-13.0	-4.5
Risk Free Return	3.6	4.0	-0.4
Model Return	-18.8	-12.4	-6.4
Selection / Residual	-3.9	0.0	-4.0
Total Monthly Linked Return	-22.7	-12.4	-10.4

Performance Attribution Analysis
International Corporate Governance versus MSCI EAFE Index
06/30/2007 - 06/30/2008

Sources of Returns - Domestic:	**Portfolio**	**Benchmark**	**Management**
Log Market Cap	4.3	0.5	3.8
E/P Ratio	0.2	-0.3	0.6
Book/Price	-7.6	-4.7	-3.0
Volatility	-3.2	-0.7	-2.5
Momentum	-3.3	-0.7	-2.6
Historic Beta	-0.6	-0.7	0.1
Msindgrp	-16.4	-16.0	-0.4
Risk Free Return	3.9	4.1	-0.2
Model Return	-22.7	-18.5	-4.2
Selection / Residual	4.8	8.3	-3.5
Total Monthly Linked Return	-17.8	-10.2	-7.6

Over the past year, Industry weights (labeled Msindgrp) have detracted 4.5% on a relative basis for the domestic portfolio, which had a meaningful underweight in the Energy sector. The effect was more modest for the international portfolio as the industry weight for Energy was closer to the benchmark. Note in each attribution, the effect of Book/Price (a common factor representing Value versus Growth). In each case, the portfolio's value bias contributed to the negative relative returns over the past year.

Overall, we feel that this performance analysis helps illuminate the inherent bias in the portfolio to value stocks and to smaller cap stocks. Additionally, the attribution analysis helps explain the causes of what has been a difficult year, relative to the Program's benchmark. Wilshire believes that the long terms results of the program (outperformance since inception) are more indicative of the long-term expected alpha potential of the Corporate Governance Investment Program.

Conclusion

In brief, we believe that the Program is well run and Staff is aware of the risks and rewards associated with activist investing. Wilshire believes that further development and diversification of the program should be a goal, as it will benefit both the overall portfolio and present more opportunities for successful co-investing.

Should you require anything further or have any questions, please do not hesitate to contact us.

Best regards,

Strategy Evaluation: CalPERS Corporate Governance Investments Program

Organization (0-100)

SCORE:	COMMENTS:
Ownership/Incentives (0-30) Direct Ownership/Phantom Stock Profit Sharing Performance Bonus Depth of Incentives Score: 5	Employees receive performance bonus only. Bonus is driven by multiple factors, some geared around the investment performance generated by the corporate governance portfolio but others related to total fund performance. Obviously, no equity ownership is available for employees.
Team (0-25) Communication Role of Manager, Research, and Operations Longevity of Team Score: 10	The Corporate Governance Investments Program has no dedicated SPM oversight as Dennis Johnson recently left the organization. Currently, the Portfolio Manager reports to SIO – Global Equity. CalPERS is conducting a search for a new SPM – Corporate Governance to replace Dennis. The staffing associated with Corporate Governance Investments has increased over the past several years, and the growth seems appropriate given the increased size of the program and the involvement of Staff in the co-investment process. The Portfolio Manager has relevant experience in asset management and has demonstrated a passion and aptitude for activist investing. This score will remain below average until the team has a SPM who demonstrates aptitude and leadership.
Quality of Key Professionals (0-15) Experience Quality of Leadership Quality of Education Score: 5	Experience and technical skill set of portfolio managers is good. However, with the role of SPM unfilled, current leadership rests with the SIO-Global Equity. While the SIO-Global Equity is also highly qualified, the lack of full-time leadership for the Corporate Governance Investments Program causes concern. CalPERS is currently searching for a SPM. The PM is appropriately concerned about process, reporting, and monitoring.

Turnover of Senior Professionals (0-15) Low (<10%), Medium (<20%), High (>20%) Score: 0	Staff turnover for CalPERS (as an organization) is high at both the senior and junior levels, including the departure of 3 CIOs in the last several years, the recent departures of the CEO, SIO-Global Equity, and the SPM-Corporate Governance Program. Lack of long-term retention incentives lead some staff to consider the organization as a "stepping stone" to better compensation in similar positions elsewhere.
Commitment to Improvement (0-15) Clear Mission Re-investment Process Enhance Score: 10	Staff is committed to generating alpha through the use of activist strategies utilizing outside managers and co-investment opportunities. This sub-asset class is research intensive and Staff dedicates significant amounts of time to covering existing investments and to sourcing new ideas. Again, the lack of a SPM and the uncertainty regarding the philosophy of the new SPM (when hired) negatively affects this score.

<u>Philosophy/Process (0-100)</u>

SCORE:	**COMMENTS:**
Market Anomaly/Inefficiency (0-40) Permanent or Temporary Clear Identification Where and How Add Value Empirical or Academic Evidence to Support Score: 35	Corporate Governance strategies have been studied extensively, with academic finding consistently supporting added value from good or improving corporate governance. Wilshire believes that shareholder activism is a long-term, sustainable source of outperformance, although it is a research intensive strategy and performance can be lumpy. In addition, there is a pronounced value bias in these strategies, as poorly governed companies rarely trade at a premium.
Information (0-15) Unique Sources, Unique Processing Score: 12	Sourcing of new fund ideas is conducted by Staff utilizing their existing network of contacts and industry sources. Staff scores proposals by managers – those meeting a minimum acceptable score are passed on to outside consultants for further due diligence and a recommendation. Staff also actively seeks co-investment ideas from the existing managers, although Staff only invests after thorough due diligence. Not every co-investment opportunity leads to capital being invested. Staff conducts fundamental research on co-investment opportunities and uses CalPERS network to provide external feedback (e.g., contacting Street analysts to discuss a company's prospects).

Buy/Sell Discipline (0-15) Disciplined/Structured Process Quantitative and Qualitative Inputs Score: 15	Hiring decisions for external managers are made after independent due diligence by Staff and an outside consultant, followed by discussion between Staff and the consultant. Termination decisions are based on performance, engagement process and changes in the view of a manager's process. Co-investment decisions are based on thorough fundamental research; discussions with the proposing manager as to the proposed engagement, its chances of success and risks to a successful outcome; and external research.
Portfolio Construction (0-15) Benchmark Orientation Risk Controls Ongoing Monitoring Score: 10	Portfolio construction reflects the mandate of the product (e.g., large cap, small cap, emerging markets, etc.) and the anticipated value-added by the manager's process. Staff has recently been given the authority to invest in emerging markets, which expands the opportunity set. Individual portfolios tend to be very concentrated with holdings ranging from 2-20 per portfolio. Most managers are benchmarked to a core index, rather than a value benchmark, despite the obvious value bias of the managers. The opportunity set looks like the core benchmark from a sector perspective, but the stock selection almost always tilts to value.
Quality Control (0-15) Return Dispersion Performance Attribution Performance Consistency Style Drift Score: 10	Style drift is minimal, as managers are purchasing underperforming (read: value) companies in an attempt to improve the company's performance. Attribution is performed by Staff and Wilshire, but concentrated portfolios mean that stock-specific risk is dominant. Both Staff and Wilshire monitor portfolios on a stock-by-stock basis on a continuous basis.

Resources (0-100)

SCORE:	**COMMENTS:**
Research (Alpha Generation) (0-40) Appropriate for Product Style Conducted Internally/Externally Quantitative/Qualitative Sufficient Databases and Models for Research How are Research Capabilities Enhanced Score: 35	Alpha generation is driven by stock selection and engagement success. Performance can be "lumpy" as not all engagements progress at the same speed. Staff proactively communicates with managers about engagement progress. Long term results have been good for the Corporate Governance Investments Program and have proven out the value-adding nature of activist investing.

Information/Systems Management (0-15) Ability to Manage Large Flows of Data Appropriate Systems for Research and Management Score: 15	Hardware and software support is very strong. Members of Staff have access to Bloomberg for research and information on current market conditions.
Marketing/Administration/Client Service (0-15) Dedicated and Knowledgeable Group Quality of Materials/Presentations of RFPs Responsiveness Measuring Client Satisfaction Score: 14	Since marketing and client service are not involved, unlike external sources for such a strategy, the full resources of the Staff will be devoted to CalPERS, as the portfolio managers will not have to travel to service other clients or market to prospects. End client (Investment Committee) has regular meetings that usually require SIO and SPM, but team is able to continue to operate in their absence. As CalPERS continues to expand the size of the Corporate Governance Investments Program, additional staff members may be needed. However, at present, staffing levels are appropriate, once the SPM position is filled.
Trading (0-30) Turnover Relative to Process Sophistication of Trading Process Measurement of Trading Costs Score: 25	Turnover in the Corporate Governance Investments Program is low, so trading costs are low overall. However, position sizes are large and careless trading can move the price of the stock being transacted against CalPERS' interests. By and large, most trading is conducted by the external managers and those processes are reviewed during the due diligence process. Wilshire's experience is that the external managers are very careful about trading and are willing to take time to build a position so that there is little information imparted to the market. Co-investments are frequently traded by CalPERS' trading desk, which Wilshire believes is an effective mechanism for trading in large blocks.

Discussion

Wilshire's score on this strategy of 67% or 201 out of 300 possible points is one of the lowest that Wilshire has assigned in the course of reviewing internally managed programs. Much of the relatively low score can be attributed to the fact that the Corporate Governance Investments Program lacks a Senior Portfolio Manager. While the SIO-Global Equity and the Portfolio Manager are highly trained, the lack of day-to-day strategy provided by a SPM warrants the relatively low scores for all Organizational scores. Wilshire would expect a substantial increase in the scoring of Organizational components when a qualified SPM is hired.